

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 144236
Christian Community Credit Union	)	
(formerly known as American Baptist	)	
Credit Union)	)	

Representing the Parties:

For Appellant:	Randy Moore, Esq. JoAn Blackstone, Esq.
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For Respondent:	Edward J. Kline, Tax Counsel III
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OPINION

This appeal is made pursuant to section 19324, subdivision (a),<sup>1</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Christian Community Credit Union for refund of franchise tax in the amount of \$4,226 for the year 1988, \$3,517 for the year 1990, \$8,327 for the year 1994, \$5,250 for the year 1995, \$17,331 for the year 1996, and \$11,645 for the year 1997. The issues presented by this appeal are 1) whether the calculation of Surplus Member Savings Capital (SMSC) under section 24405, subdivision (c), as interpreted by our decision

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<sup>1</sup> Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

in the *Appeal of San Francisco Police Credit Union* (99-SBE-002), decided January 7, 1999 (*SF Police Credit Union*), requires a pro rata allocation of equity capital and savings capital to the amount of member loans, and 2) whether respondent claims a manifestly unreasonable position entitling appellant to its fees and costs.

Appellant is a state-chartered, member-owned credit union subject to section 24405, describing several tax deductions available to cooperatives, such as credit unions. In *SF Police Credit Union*, we reviewed the history, the language, and the interaction of subdivisions (a), (c), and (d), of section 24405 in the context of the deduction provided in subdivision (c) and the definition of SMSC set forth in subdivision (c).<sup>2</sup> In *SF Police Credit Union*, we offered clarification and guidance regarding the interaction and application of the subdivisions of section 24405. The current appeal, however, demonstrates that confusion apparently exists regarding the application of section 24405 and our opinion did not alleviate this confusion. In order to avert any further confusion, we issue this written opinion affirming several of our conclusions in *SF Police Credit Union* and clarifying others. To the extent our opinion in *SF Police Credit Union* appears to conflict with our conclusions expressed in this opinion, *SF Police Credit Union* will not be followed.<sup>3</sup>

Prior to the enactment of subdivision (c), section 24405 provided a credit union a deduction only for the income arising from the credit union's business activities for or with its members, i.e., income arising from loans the credit union made to its members. A credit union determined the original deduction in section 24405 based on the source of income identified in its traditional accounting records. With the addition of subdivision (c) in 1987, the original deduction found in section 24405 was placed into subdivision (a). New subdivision (c) established an additional deduction for credit unions for the income generated by the investment of member savings capital in excess of the member savings capital loaned to members of the credit union (SMSC). The deduction in subdivision (c) is based on the source of the funds used to generate the income (SMSC), rather than the source of the income received as is the case with the deduction in subdivision (a) (income from loans to members). In the 1987 amendment, the legislature also included nonstatutory intent language stating: "It is not the intent of the Legislature to exempt, within the provisions of Section 24405 of the Revenue and Taxation Code, 'equity capital,' as that term is defined in subdivision (b) of Section 14400 of the Financial Code."

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<sup>2</sup> Section 24405, subdivision (c), defines SMSC as "the savings capital of credit union members which is in excess of the amount of savings capital which is loaned to members of the credit union."

<sup>3</sup> At this point, we wish to make it clear that we do not believe our opinions in the current appeal conflict with our opinions in *SF Police Credit Union*. As evidenced by the fact of the current appeal, however, others apparently find such conflicts, and thus we issue this opinion to clarify the matter.

Subsequently, the legislature added subdivision (d) to section 24405 containing a deduction for income resulting from reciprocal transactions with member credit unions, regardless of the source of funds.<sup>4</sup>

Money is generally a fungible commodity, thus the various subdivisions of section 24405 present potentially competing and/or overlapping deductions. In Franchise Tax Board Notice 92-7, respondent adopted a two-part allocation formula for determining the amount of investment income attributable to SMSC (and thus deductible) and the amount of investment income attributable to equity capital (and thus taxable). The formula in Notice 92-7 first divides appellant's SMSC by the sum of appellant's SMSC and equity capital producing a percentage figure (the allocation percentage). Second, the allocation percentage is applied to the taxpayer's investment income to determine the portion of the taxpayer's total investment income deductible because it arose from SMSC. We affirmed respondent's use of this formula;<sup>5</sup> however, we directed a change to respondent's method of calculating SMSC for use in the formula. These directions appear to be at the heart of the current appeal.

In *SF Police Credit Union*, we directed respondent to use the year-end figures appearing on a credit union's standard financial statements for SMSC and equity capital<sup>6</sup> when calculating the allocation percentage. We affirm that directive. We further directed respondent in *SF Police Credit Union* to compute SMSC by subtracting from the taxpayer's member savings capital only member loans, not member loans and the amount of any transactions with member credit unions. The statutory definition of SMSC equals member savings capital less member loans, and does not allow for a further reduction of that figure (SMSC) by member transactions.<sup>7</sup> We again affirm that directive.

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<sup>4</sup> We recognize section 24405, subdivision (d), did not become effective until January 1, 1993, and thus is not applicable to the first two years at issue in this appeal.

<sup>5</sup> As we stated in *SF Police Credit Union*, the allocation percentage and the formula are necessary only when a taxpayer does not present sufficient evidence of direct tracing of its income. We affirm that conclusion.

<sup>6</sup> We directed respondent to determine equity capital in accordance with the definition set forth in Financial Code section 14400, subdivision (b). We affirm that directive.

<sup>7</sup> In a strictly technical sense, we do not believe respondent was incorrect in its Notice 92-7 in reducing savings capital by both member loans and transactions with member credit unions in its calculation of SMSC, given the legislative "intent" in the 1987 amendment to not exempt equity capital from taxation. Since section 24405, subdivision (d), provides a deduction for all income resulting from reciprocal transactions with member credit unions, then the source of funds for transactions with other member credit unions is deemed to come from savings capital if the legislature did not intend to exempt equity capital from taxation. However, in *SF Police Credit Union* we recognized 1) the statutory definition of SMSC did not provide for reduction of savings capital by transactions with member credit unions, and 2) the potential for exceeding the amount of a credit union's savings capital if both member loans and credit union transactions were subtracted from savings capital. If it was determined no SMSC existed, then the income deduction in

Respondent's calculation of SMSC for purposes of the allocation percentage presents the primary concern in the current appeal. Appellant argues respondent fails to properly apply our directives regarding the calculation of SMSC as set forth in *SF Police Credit Union*, and as a result improperly calculates SMSC, both in its Legal Ruling 2001-2 and in its audit of appellant. The incorrect calculation of SMSC, appellant contends, in turn causes error in the allocation percentage used to determine the deductible and nondeductible portions of income received by appellant from nonmember investments, specifically, investments in marketable securities. Appellant asserts our opinion in *SF Police Credit Union* requires allocation of equity capital to member loans for purposes of calculating SMSC. Respondent contests this position, citing language from the opinion it contends is contrary to appellant's argument. It is this issue we intend to clarify in this appeal.

Appellant correctly states our intent: when calculating SMSC for purposes of applying the allocation percentage in determining deductions under subdivision (c), respondent shall allocate on a pro rata basis equity capital and savings capital to member loans. To allocate equity capital and share capital on a pro rata basis, respondent shall divide savings capital by the sum of savings capital and equity capital and multiply the resulting percentage by the amount of member loans. The portion of member loans attributable to savings capital is then subtracted from total savings capital to determine SMSC.

To illustrate the proper procedure for calculating SMSC, we utilize respondent's example from its Legal Ruling 2001-2, as modified by appellant. In the example, the credit union has savings capital of \$100,000, equity capital of \$10,000, and loans to members of \$70,000. The pro rata share of savings capital equals \$100,000 divided by \$110,000 (savings capital of \$100,000 plus equity capital of \$10,000), for a percentage of 90.91 percent. The percentage is then multiplied by the amount of member loans to determine the amount of member loans attributable to savings capital (90.91 percent x \$70,000 = \$63,637). SMSC thus equals \$36,363, calculated as follows: \$100,000 (total savings capital) minus \$63,637 (savings capital portion of member loans). In Legal Ruling 2001-2, respondent does not allocate equity capital to member loans, but improperly computes SMSC as follows: \$100,000 (savings capital) minus \$70,000 (member loans) equaling \$30,000.

Appellant also requests an award of fees and costs pursuant to section 21013, arguing respondent's position "is and has been manifestly unreasonable subsequent to the opinion in the *Appeal*

(..continued)

subdivision (c) for investment of SMSC would be rendered meaningless. We did not believe the legislature intended to enact a meaningless statute, and expressed this conclusion in *SF Police Credit Union*. Thus, in an attempt to balance the stated legislative intent with the preservation of the enacted deductions, we concluded in *SF Police Credit Union* SMSC equals savings capital reduced by member loans only.

*of San Francisco Police Credit Union.*” Respondent contends California Code of Regulations, title 18, section 5093, subdivision (b), precludes us from taking jurisdiction of the claim since we have yet to render a final decision in the appeal. Respondent is correct. It is premature for us to consider appellant’s request because appellant has not yet filed an appropriate claim with this Board for the claimed fees and expenses; such a claim needs to be filed within one year of the date of our decision. (See Rev. & Tax. Code, § 21013, subd. (a)(1); Cal. Code Regs., tit. 18, §§ 5091 & 5093, subd. (b).)

In conclusion, we affirm our previous directives to respondent: Respondent shall apply the formula set forth in its Notice 92-7, as clarified in *SF Police Credit Union*, and in this opinion, and only when a taxpayer fails to present sufficient evidence of direct tracing. In applying the formula, respondent shall use the year-end figures for both equity capital and SMSC and shall adhere to the definition of equity capital set forth in Financial Code section 14400, subdivision (b); when calculating SMSC for purposes of the formula, respondent shall deduct only member loans from member savings capital. Pursuant to the clarification offered in this opinion, we further direct respondent, when calculating SMSC, to first allocate on a pro rata basis savings capital and equity capital to the amount of member loans. Respondent shall then utilize the amount of member loans allocated to savings capital in the calculation of SMSC, as described in this opinion.

**ORDER**

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Christian Community Credit Union for refund of franchise tax in the amount of \$4,226 for the year 1988, \$3,517 for the year 1990, \$8,327 for the year 1994, \$5,250 for the year 1995, \$17,331 for the year 1996, and \$11,645 for the year 1997 be and the same is hereby reversed.

Done at Sacramento, California, this 3rd day of December, 2002, by the State Board of Equalization, with Board Members Mr. Chiang, Mr. Klehs, Mr. Parrish and \* Ms. Marcy Jo Mandel present.

John Chiang\_\_\_\_\_, Chairman

Johan Klehs\_\_\_\_\_, Member

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Claude Parrish\_\_\_\_\_, Member

\*Marcy Jo Mandel\_\_\_\_\_, Member

\*For Kathleen Connell per Government Code section 7.9.

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